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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date:

OCT - 6 2000

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Release Copies to District

Contact Person:

ID Number: Date

Signature
Telephone Number:

Employer Identification Number:

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

You were incorporated on [REDACTED] in the State of [REDACTED]. Your stated purposes are, "to operate a nonprofit organization for the betterment of the education of children through the use of computers." Specifically, the organization provides an internet homework service intended to benefit parents, teachers and elementary school students. You state that educational games will be distributed to schools free of charge or at cost. However, you have not stated how much of your software will be distributed at no charge, nor have you indicated for how long such free distribution will continue.

You were established by [REDACTED]. [REDACTED] also owns a for-profit business called [REDACTED]. [REDACTED] is an application service provider, with the infrastructure to host and develop internet applications for business customers who subscribe to its products and services. Your initial Board of Directors consisted of [REDACTED] and other officers of [REDACTED]. You now have a Board of Directors made up of persons unrelated to [REDACTED]. However, your officers are the same individuals who are officers of [REDACTED].

On [REDACTED], a Software Development Agreement was executed by you and [REDACTED]. This agreement was signed by [REDACTED] for both [REDACTED] and you. The Agreement states that you shall compensate [REDACTED] for the design, development, production, installation and testing of the customized computer program and related printed materials (software). The Agreement also states that you agree that all material, including all computer programs and software prepared for you by [REDACTED] shall belong exclusively to [REDACTED]. The Agreement states that [REDACTED] can terminate the contract for a number of reasons. The Agreement contains no provisions that would permit you to terminate the contract for any reason. You state that all services provided by [REDACTED] are provided at cost and not at the rates charged for the same resources to other [REDACTED] clients.

You, as tenant, have also entered into a Premises and Facilities Lease Agreement with [REDACTED], the landlord, dated [REDACTED]. Your monthly rental payment is \$[REDACTED].

According to an attachment to the lease, however, this is not merely an agreement for the use of office space. You are paying one-third of [REDACTED] monthly operating costs (other than salaries) including such items as training, office supplies, and depreciation on hardware and software. This agreement was also signed by [REDACTED] for both [REDACTED] and you.

Section 501(c)(3) of the Code provides for the exemption of organizations that are organized and operated exclusively for charitable, educational or scientific purposes, no substantial part of the activities of which consists of attempting to influence legislation.

Section 1.501(c)(3)-1(d)(3) of the Income Tax Regulations defines the term "educational" as including the instruction of the public on subjects useful to the individual and beneficial to the community.

Section 1.501(c)(3)-1(a)(1) of the regulations provides that in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

In Church by Mail v. Commissioner, 765 F.2d 1387 (9th Cir. 1985), aff'g TCM 1984-349, the courts considered the qualification for exemption of an organization which purchased advertising and other services from corporations owned by its officers. The Tax Court found that the Church was operated for the non-exempt purpose of providing a market for the services of the for-profit business owned by its officers. The 9th Circuit Court of Appeals, in affirming the Tax Court's decision, stated:

The critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the Church.

[REDACTED]

In International Postgraduate Medical Foundation v. Commissioner, T.C. Memo 1989-36, the Tax Court considered the qualification for exemption of an organization which provided purportedly educational travel tours for doctors. All tour services were provided under a contract with a for-profit travel agency owned by one of the Foundation's three directors. The Tax Court stated:

When a for-profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of section 501(c)(3), even if it furthers other exempt purposes.

In Better Business Bureau v. U.S., 326 U.S. 279 (1945), the Supreme Court stated that the presence of even a single non-exempt purpose, if more than insubstantial in nature, will defeat exemption under section 501(c)(3) of the Code, regardless of the number or importance of the truly exempt purposes.

Rev. Rul. 72-369, 1972-2 C.B. 245, discusses the qualification for exemption of an organization formed to provide managerial and consulting services at cost to unrelated exempt organizations. The ruling holds that the organization is not exempt because furnishing the services at cost lacks the donative element necessary to establish the activity as charitable.

The development and marketing of educational software is a trade or business that is ordinarily carried on for profit. Providing such software at "cost" lacks the donative element necessary to establish this activity as charitable. See Rev. Rul. 72-369, supra. You state that your software will be distributed free or at cost, but you have not explained what proportion of your activities will consist of the free distribution of software, or for how long free distribution will continue. Since distribution at cost does not further an exempt purpose, we are unable to conclude that your activities are educational or charitable.

The private benefits received by your former president, [REDACTED], and her for-profit organization, [REDACTED], are more than insubstantial in nature. You compensate [REDACTED] for the software, however, [REDACTED] owns the software. It appears that [REDACTED] benefits substantially by having its costs covered even if [REDACTED] receives no profit on the transaction. [REDACTED] may be providing its services to you at cost, however, it is also developing a new market for its products while attracting customers and developing expertise and, thus, serving the private interests of [REDACTED] to a substantial degree. The ratification of the Software Development Agreement by your new board has little meaning since, by its terms, you could not terminate the agreement even if the board declined to ratify it. It appears that substantially all of your expenditures will flow to [REDACTED] in one way or another. In this respect you are very similar to the organizations described in Church by Mail and International Postgraduate Medical Foundation.

Furthermore, it appears that you would like us to view your activities as entirely separate and apart from the activities of [REDACTED]. A realistic view of the nature of your activities, however, shows that your activities are inextricably intertwined with those of [REDACTED] notwithstanding that [REDACTED] is no longer on your board of directors. This type of arrangement does not confer the kind of charitable benefit on the community which section 501(c)(3) requires. Thus, despite your stated educational purposes, you are not operated exclusively for charitable purposes under section 501(c)(3) of the Code.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

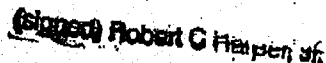
If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service
T:EO:RA:T:3, Room 6137
1111 Constitution Ave, N.W.
Washington, D.C. 20224

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,



Robert C. Harper, Jr.
Manager, Exempt Organizations
Technical Group 3